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# **Worlds Apart? Labour Unions, Wages and Monetary Integration in Continental Europe**

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## **Abstract**

This paper examines the problems of the single currency in light of the organization of labour relations in the member-states and their interaction with monetary policies. Continental (western) Europe consists of two very different systems of employment and labour relations, roughly coinciding with 'coordinated market economies' (CME) in the north-west of the continent, and 'Mixed Market Economies' in the south. These differences in employment relations and wage-setting systems implied that, against the background of a relatively restrictive one-size-fits-all monetary policy in place since 1999, the north-west of the continent systematically improved its competitiveness, while the south lost competitiveness in parallel. Small differences between the two groups of countries at the start of EMU thus were accentuated and, against the background of low growth and an almost closed E(M)U economy, the northern CMEs accumulated current account surpluses while the GIIPS ran into severe balance of payments problems in 2010 and 2011. The sovereign debt crises of 2010-11, which threatened the survival of the Euro-zone itself in November and December 2011, simply reflected these structural imbalances: current account deficits are financed through debt, private and public. The problem with EMU, in other words, is one of current accounts, not fiscal deficits. The paper reconstructs the construction and emergence of this system through an examination of the development of wage-setting systems against the background of monetary integration in Europe since the second oil shock.

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## **Keywords**

Macroeconomics, political economy, EMU, varieties of capitalism, labour relations

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## I. Introduction

In 2009, the Euro celebrated its tenth anniversary. Champagne corks popped in Brussels and Frankfurt at self-congratulatory birthday parties, with the added bonus of the Euro as a safe umbrella against the turmoil in financial markets. Less than two years later, when the financial crisis of 2007-08 rapidly spilled over into a sovereign debt crisis on the continent and beyond, the single currency was facing an existential crisis. The combination of massive bank bail-outs, low growth, increased expenditure when the automatic stabilizers kicked in, and discretionary fiscal stimulus measures implied that the public purse would be heavily taxed in any case. In addition, some member states, from the always fiscally fragile Greece to the considerably more robust Italy and Spain (which had been running primary surpluses for most of the last decade), were threatened with exorbitant interest rates on government debt. Greece, Portugal, and Ireland called in the IMF and were forced to borrow from other EU governments in order to remain functioning states. The diagnosis, both in the press, among politicians, and in academic circles, was unequivocal: a toothless Stability and Growth Pact invited fiscal profligacy, while labour market rigidities prevented adjustment. Less than two years after the world's tempestuous flirt with Keynesianism in response to the financial meltdown, it seemed, orthodox economic recipes had made a strong come-back.

This paper looks elsewhere for answers: the problems of the single currency are directly related to the organization of labour relations in the member-states and their interaction with monetary policies. Somewhat schematically, continental (western) Europe consists of two very different systems of employment and labour relations, roughly coinciding with what Hall and Soskice (2001) call 'coordinated market economies' (CME) in the north-west of the continent (including Austria—geography is not the defining characteristic of this group or the others), and, for want of a better term, 'Mixed Market Economies' in the south, in the form of the now infamous GI(I)PS, Greece, Italy, (Ireland), Portugal, and Spain (Hall & Soskice 2001; Hancké et al. 2007). The main difference between the two lies in the nature of the actors and the configuration of institutions and rules that they face. In CME, strong labour unions encounter strong employers associations, particularly in the export sector; as a result, they negotiate wage settlements which simultaneously safeguard real wages and profitability; and that is done through negotiating wage rates between a floor set by inflation and a wage ceiling set by labour productivity. Strong systems of wage coordination then transmit these wage rates to the rest of the economy. In MME, the situation is different. First of all, the state regularly has to step in to compensate for the lack of autonomous bargaining capacity among the key actors. Secondly, cross-industry wage coordination is considerably weaker than in the north of Europe, and as a result inter-sectoral wage drift is endemic. These differences in employment relations and wage-setting systems implied that, against the background of a relatively restrictive one-size-fits-all monetary policy in place since 1999, the north-west of the continent systematically improved its competitiveness, while the south lost competitiveness in parallel. Small differences between the two groups of countries at the

start of EMU thus were accentuated and, against the background of low growth and an almost closed economy (the virtual economy known as EMU trades less than 10% outside the EU), the northern CMEs accumulated current account surpluses while the GIIPS ran into severe balance of payments problems in 2010 and 2011 (Scharpf 2011). The sovereign debt crises of 2010-11, which threatened the survival of the Euro-zone itself in November and December 2011, simply reflected these structural imbalances: current account deficits are financed through debt, private and public. The problem with EMU, in other words, is one of current accounts, not fiscal deficits.

This paper starts with a review of the debate on the political economy of EMU and the crisis that the single currency has faced in the last few years, and develops the argument above in contrast to the prevailing explanations. It then continues to its empirical point of gravity: in three sections the paper reconstructs the development of wage-setting systems against the background of monetary integration in Europe since the second oil shock—the emergence of the Deutschmark-bloc and its effects on wage-setting and labour relations, the Maastricht process, and the introduction of the Euro. The final section concludes by putting this analysis in the wider context of the debates on EMU.

## II. Understanding the crisis of EMU

The crisis of EMU is an excellent place to take stock and analyse what makes EMU fragile: tensions such as those provoked by a major crisis have the potential to bring out the problems with an institutional architecture that may be obfuscated by its operation under 'normal' circumstances. Four types of explanations have been offered for why EMU faces the problems it does. The first is an old stalwart of orthodox economics: labour market regulation. The basic idea harks back to theories of optimal currency areas. If all other macro-economic adjustment mechanisms—monetary and fiscal policies as well as exchange rates—are more or less fixed, as they are in EMU, labour markets and therefore wages have to become more flexible. The lack of labour market flexibility in the south thus exacerbated the pre-existing problems in that region. This perspective certainly helps us understand part of the problem—although with an ironic twist, as I will argue later on. One observation, however, should give pause for thought: the at least equally inflexible labour markets in countries such as Germany, Austria and the Netherlands have not produced the same adjustment problems. The highly organized ('rigid') wage-setting systems in the north have, in fact, been at the basis of their strong economic performance in the shape of low inflation (and relatively low unemployment) and of their micro-level counterpart, international competitiveness.

The other orthodox interpretation of the crisis—and the purveyor of many unpleasant newspaper headlines, especially in tabloids across the northern part of the continent during the crisis years—was fiscal mismanagement, possibly supported by aloof capital markets. During most of the Euro's first decade, interest rate differentials between Germany's baseline and Greek and Italian debt were negligible—at least as much a reflection of the lack of credibility of the no bail-out clause in the Maastricht Treaty as of the massive incompetence of rating agencies who were supposed to report on the relative risk in government debt. Governments in the south thus were able to run up large public debt without paying a penalty in higher interest rates, which created the fiscal imbalances at the heart of the euro-crisis in 2010 and after. While this explanation may help understand the Greek situation, it meets its limits when used to understand the problems of Ireland and especially Spain, two countries that, in fact, ran budget surpluses until the financial crisis of 2008. In addition, as Martin Wolf of the *Financial Times* has pointed out (6 December 2011), during the period between the start of EMU in 1999 and the start of the financial crisis in late 2007, only Greece ran, averaged over that period, a public deficit considerably beyond the three per cent limit imposed by both Maastricht and the Stability and Growth Pact—hardly a persuasive indication of widespread fiscal irresponsibility.

Spain and Ireland are, not surprisingly, at the basis of a third explanation, which revolves around asset price inflation and bursting bubbles. While headline consumer price inflation has hardly been problematic on the continent, both in the aggregate and in most individual

member-states, the ultra-low interest rates in some of the member-states stoked an asset boom: low interest rates begot cheap mortgages, which begot massively rising housing prices and, on the back of that, a construction boom. This dynamic gets us closer to the problem, but it fails to understand outcomes in countries like Greece, Italy and Portugal, whose sovereign debt problems could hardly have been fuelled by asset price inflation since that was more or less absent in those countries.

The final possible explanation was poor financial regulation and a host of dangerous mistakes on the back of that. Ireland is the case in point here: lax regulation attracted risky capital, which maximized profits in the implicit knowledge of a government bail-out if and when things were to go wrong. Financial developments in Ireland without doubt were not as well regulated as they could have been, and the decision in 2008 by then Prime Minister Brian Cowan to guarantee all bank debt will certainly go down as one of history's largest self-inflicted policy mistakes. But the lack of financial acumen in Irish government circles hardly explains most of the other problematic cases. Regulation in Spain, for example, one of the only other countries with a sizeable, active and open banking sector, was never considered a problematic aspect of the new Spanish model. And most other countries facing fiscal problems in 2010 and 2011 had, in fact, relatively strict regulation or, as in Italy, a relatively closed banking sector.

All four of these explanations help us understand pieces of the puzzle—but, at best, only pieces. One problem that they share is that they consider the problem to be very similar everywhere, thus implicitly also suggesting that the problems (and the solutions) are primarily or even solely found at the national level. Labour market flexibility, fiscal rules, and better regulation remain subject to national policy-making, helped but not steered by European institutions. This assumption is probably incorrect: even granting the arguable point that the problems were the same everywhere, the different organization of domestic economies in Europe means that they probably do not have the same effects in every country. More importantly, there are reasons to believe that the new international political economy associated with EMU is itself part of the problem: some of the dynamics underlying the Euro crisis, such as the massive current account divergences, almost perfectly coincide with the 1999 start of EMU. Combining these two insights—one loosely emanating from a 'Varieties of Capitalism' approach to comparative political economy, and the other inspired by New Keynesian macro-economics (Carlin & Soskice 2006)—suggests a more systemic explanation of the crisis.

One key stylized fact that helps us understand the more structural dimension of the crisis of EMU is that since its inception in 1999, EMU has witnessed an increased divergence of inflation and wages, as well as of economic performance more generally in the single currency area. In part this has been a relatively standard, more or less anticipated process of inter-country adjustment, especially since some countries, most notably Germany, entered EMU with an overvalued exchange rate. But it is equally a consequence of Germany's

reliance on exports for growth, which imposes a tight wage moderation strategy on its key industrial sectors, diligently followed by unions, both in the export and in the sheltered sectors, including the public sector (note that the ‘wage moderation’ referred to in this paper is, unless explicitly stated otherwise, expressed in unit labour costs—abbreviated as ULC henceforth—which measure the ratio of wage rates over labour productivity rates). This neo-mercantilist adjustment argument, again, helps us understand part of the problem: it explains why competitiveness rose in the north and fell in the south. But it probably attributes too much to a prevailing consensus among the key political-economic actors in Germany and particularly to their capacity to set relative wage rates. Leading trade unions in Germany, among them the IG Metall and ver.di have, in fact, campaigned for higher wages for most of the euro’s existence, but failed to gain these. Explaining why these strong labour unions have been unable to set wages in their favour requires a more structural approach: in the EMU set-up, as I will show with a simple model below, there are strong systemic pressures that force a divergence of inflation and wage rates across the euro-zone (see Hancké & Soskice 2003 for a more formal elaboration of the basic idea).

Imagine, for ease of exposition, that EMU consists of two economies of equal size, called DE (i.e. Germany with its north-west European neighbours, including Austria) and RE (for Rest of Europe). At the start of EMU, DE’s inflation rate is, because of its more strongly coordinated wage-setting system, slightly below RE’s; they average two per cent, which is the ECB’s inflation target. Since the ECB sets its interest rate for all members to reflect the difference between the target and the actual (i.e. the aggregate/average) inflation rate of DE and RE, the real interest rate (the nominal interest rate that the ECB sets for all minus the country-specific inflation rate) is therefore lower in the country with high inflation (RE) and higher in the low-inflation country (DE). These differences between real interest rates and domestic institutions have several consequences that are poorly understood.

First of all, monetary policy is pro-cyclical. The country with higher inflation in effect has a more accommodating monetary policy than it should, because the bank’s target is lower than its actual inflation rate. The country with a lower inflation rate, on the other hand, will have an unnecessarily restrictive monetary policy, which will not have a significant effect on price dynamics (since inflation is low already), but only on growth. Note that the opposite would happen if monetary policy were decided for each country individually (Allsopp 2002; 23 ff.): if inflation in DE were to fall, DE’s central bank would almost certainly lower the nominal, and therefore in effect the real, interest rate; if inflation rises in RE, RE’s monetary policy would tighten. None of that happens in EMU, where rising inflation is implicitly rewarded through a falling real interest rate. In part, of course, this pro-cyclical dynamic is compensated by a lower real exchange rate (RER) in the low-inflation countries, which improves competitiveness and therefore exports. However, two caveats are in order here: one, this compensatory effect is limited to the export sector, which makes up at most half of the GDP of small economies in EMU and not more than a quarter of output in large economies; most importantly, perhaps, a RER depreciation in the low-inflation countries is at the root of their



stellar competitiveness performance, and thus indirectly at the basis of massive current account deficits in countries with a higher RER. A depreciation of the RER in the low-inflation countries is part of the problem, in other words, not the solution.

The second ill-understood effect is that the lower real interest rate that RE has faced during the first ten years of EMU feeds into a path of higher growth in RE, fuelling (wage) inflation. At the same time, the tighter than necessary monetary policy imposes further disinflation through wage moderation on DE. The very small differences in inflation that existed at the start of EMU thus have become more pronounced in the second round (rising asset prices fuelled inflation in RE, externally imposed disinflation further reduced export prices in DE) and the perverse pro-cyclical effects gain in strength, pushing inflation rates and competitiveness of DE and RE on sharply diverging paths.

Finally, the differences in wage setting between DE and RE play a crucial role in this process. Not only did different wage-setting systems put DE and RE on different tracks from the start; in addition the ability of DE to counter inflationary pressures through wage coordination around more slowly growing unit labour costs is almost perfectly mirrored by the inability of RE to do so. Since inflation is more of a problem in RE (though hidden under the beneficial effects of very low real interest rates), the lack of capacity to disinflate implies that RE slowly but steadily loses competitiveness relative to RE. In itself that does not have to be deeply problematic: if RE can grow through trade outside EMU, it can compensate its falling competitiveness within EMU through rising competitiveness outside EMU. But EMU is essentially a closed trade area, with only about ten per cent of GDP leaving the single currency zone, most of which goes to other EU member states. Within such a closed trade bloc which, in addition, has faced a relatively low growth regime since its inception, DE's rising competitiveness must imply RE's falling competitiveness. Trade in EMU has, in effect, become a zero-sum game in which one's gains are another one's losses, and DE's improving competitiveness and current account surplus are mirrored in current account deficits in RE.

What follows traces the design and the emergence of this system back to the start of monetary integration in Europe, the construction of the Deutschmark-bloc within the European Monetary System. It then continues with the generalization of the model to the rest of Europe through the Maastricht process in the 1990s. At the start of EMU, the political economy of the prospective euro-zone member states was, in effect, a robust disinflationary system, calibrated by the interaction between strong wage setters and central banks. The introduction of the Euro changed all that by transferring monetary policy to a single central bank without a parallel centralization of wage setting and fiscal policy. The outcome was a dramatic divergence of inflation rates and competitiveness.

### III. Labour markets and monetary integration in Europe: a drama in three acts

The key point of this paper is that the crisis of the Euro in 2010-11 has to be understood against the longer-term history of monetary integration in Europe, and most importantly, the interaction between that process and the evolution of domestic wage-setting systems. Let us start with giving credit where it is due: older theories of optimal currency areas were probably right in their broad implications that adjustment in a single currency area without fiscal federalism or fiscal discretion takes place through labour markets; they were wrong, however, in the substantive policies that this entailed. Put simply, the first steps of monetary integration—before, it is important to point out, the introduction of a single monetary policy—forced individual member states to reorganize their domestic macro-economies and their wage-setting systems in particular. Yet, and this where optimal currency area theories were wrong, this did not entail more labour market flexibility, but more central coordination (and therefore more organized labour markets, with strong trade unions and employers associations). Monetary integration, from the Deutschmark-bloc in the early 1980s to the institution of EMU, produced its best results in terms of economic performance when labour markets evolved into more rather than less centrally organized arrangements. In Europe, as the balance of this paper will analyse, this process took place in three stages: the construction of the DM-bloc at the core of the EMS, the Maastricht process and the emergence of social pacts in response to the convergence criteria, and the period after the introduction of the Euro in 1999, which installed the ECB at the helm of monetary policy.

#### ***III.1 Act I: The construction of the Deutschmark bloc***

In the first half of the 1980s, several countries in north-western Europe, including France, embarked on deeper monetary integration. Austria, Belgium, Denmark, France and the Netherlands pegged their currencies to the Deutschmark (DM), thus importing the credibility of the Bundesbank in fighting inflation. This monetary anchoring was not without a cost, however. Aligning inflation and interest rates required disciplining labour unions: wage growth had to become non-inflationary, since upward price/wage pressures forced national central banks to raise interest rates in order to maintain the exchange rate peg. More importantly, it required that wages in the sheltered sector, primarily in the public sector, followed wage developments in the exposed (primarily manufacturing) sector, where external competitiveness was a strong disinflationary anchor.

Governments, supported by conservative central banks, played a critical role in this alignment of wages during this period. Central banks were, in effect, last movers in this set-up, always in a position to punish wage settlements that threaten monetary stability. The exposed sector, consisting mainly of the manufacturing export sector, however, does not

require such a back-stop function by the central bank, since it faces a market-imposed competitiveness constraint on wage setting as a result of economic integration. The sheltered sector, and the public sector in particular, by definition do not face such a constraint. The wage restraint policies imposed by central banks and governments thus targeted the sheltered sector, specifically wages in the highly unionized public sector, and forced it to follow wage rates adopted by the exposed sector. Not surprisingly, imposing such constraints against the will of strong labour unions was far from easy.

All countries aspiring to DM-bloc membership in the early 1980s faced a period of protracted social conflict when governments pegged currencies to the DM and thus were forced to contain wage growth and public spending as a result. Both the number of strikes and working days lost to strikes, in the public sector in particular, increased suddenly and significantly in the years leading up to the formal peg between the domestic currency and the DM. Belgium and the Netherlands faced a massive public sector strike in the autumn of 1983, which paralysed large parts of the countries for several weeks. The strikes ultimately ended in defeat for the public sector unions, and led to the institutionalized subordination of wages in the public sector to those in the private exporting sector. In Denmark the number of working days lost through strikes jumped a massive 500% from about 160 strikes on average in 1982, 1983 and 1984 to 820 in 1985, while working days lost to strikes increased from about 100,000 on average before 1985 to over 2 Million in that year (source: ILO Labour Statistics). In France the high-strike years 1983-1985, immediately following the Mitterrand U-turn on economic policy, the Franc-DM peg, and the forced disinflation after 1982 (Taddéi & Coriat 1993), heralded the shift toward a regime where labour was, in effect, sidelined on the political-economic scene. Between 1980 and 1985, Belgium, Denmark, France and the Netherlands combined passed no fewer than thirteen laws that aimed at containing wage growth in the public sector, with the effect that average annual real wage growth for the 1980s in Belgium was 0%, negative in the Netherlands, and below 2% in Denmark, after a decade during which these were, for the same countries, 7.5% (BE), 5.5% (NL), and 5.4% (DK) (Johnston 2011: 80-81). More, therefore, than keeping strong unions in the private (exporting) sector under control, government and central bank policies were aimed at reducing the wage margins of the public sector.

The outcome of this period of social conflict was a tightly organized system in which national central banks of the DM-bloc members were hierarchically linked to the Bundesbank, labour unions (and wages) in the exposed sector hierarchically linked to German wage setting, and public sector wages in each country hierarchically linked to exposed sector wages. The first of these linkages assured the credibility of the peg: national central banks made clear to domestic audiences that they would defend the currency, even if that entailed raising interest rates to a prohibitively high level. The second linkage, between the key German trade unions and their counterparts elsewhere, assured that the German set-up with a strong conservative central bank that disciplined excessive wages was transmitted to all other countries in the currency bloc. Wages outside Germany thus were kept under control through two

mechanisms: one was direct wage shadowing, whereby wages outside Germany grew, adjusting for labour productivity, at a similar rate as German wages; the other was provided by credible conservative monetary policies as the back stop in case of excessive wage settlements.

### ***III.2 Act II: Adjusting to Maastricht***

This set-up became the template for future monetary integration. When the Maastricht Treaty in 1991, mapping the road to EMU, was negotiated, average inflation differentials between the DM-bloc and the other economies in the EMS (Italy, Spain, Portugal and Greece) were about nine per cent (all inflation data are taken from the OECD Employment Outlook 2002). By the late 1990s, a few months before the introduction of the Euro, inflation rates across the prospective Euro-zone had converged on an average slightly above one per cent, with a differential between the DM and non-DM countries of just one per cent and, per Maastricht criteria, none more than one and a half per cent above the best performers.

The importance of inflation in this reasoning is that it is, despite the formal multiple targets in the Maastricht Treaty, the key variable for meeting the convergence criteria: stable domestic prices not only were a target in themselves, but they also stabilized both the currency peg and the interest rate against the key target rates embodied in the Treaty. Long-term interest rates thus fell, both as a result of the exchange rate peg and through imported credibility, which alleviated budgetary pressures in turn. Whatever other conditions may have been necessary, keeping domestic inflation under control was vital for a country's entry into EMU.

Governments, assisted by central banks, again played a crucial role in this process. In essence, an implicit deal was proposed everywhere along the following terms: if the social partners agreed to keep wage growth under control and refrained from raising prices, governments would support those disinflationary moves by co-opting labour market parties in major welfare, labour market and budgetary reforms, while central banks would keep interest rates as low as possible; if social partners failed, however, determined governments and central banks would reduce inflation nonetheless, almost certainly with higher social costs (and possibly higher political costs for governments, but these would have to be weighed against the political costs of non-EMU membership). In a subtler, and definitely more cooperative form, therefore, these post-Maastricht arrangements thus replicated the government policies and institutions of the prospective DM-bloc countries almost a decade earlier (Fajertag & Pochet 1997).

But social partners in these countries were not necessarily able to deliver low wage inflation very easily. Southern Europe has a long history, in fact, of failed attempts at instituting centralized incomes policies and more broadly neo-corporatist decision-making structures to

steer the economy, usually associated with competition between ideologically opposed labour union confederations, low union density, or the organizational inability of federations to control lower-level labour unions (see, for example, Rhodes & Molina 2007). In the past, the state stepped in to compensate for this lack of organization on the labour side, with a comparatively heavy hand in labour law and employment relations, and the same happened during the Maastricht adjustment process in the 1990s. The implicit deal sketched above was sanctioned in social pacts: governments offered consultation and negotiation on the means for wage and fiscal restraint if social partners agreed on the broad targets (which themselves followed the Maastricht Treaty: low and stable inflation, a stable exchange rate, a low and stable interest rate, and fiscal consolidation with a deficit level of 3% and a debt level of 60% of GDP). Even the countries where the past caught up with the social partners and government and where a social pact turned out to be impossible to reach, ended up negotiating an incomes policy, either stand-alone or as part of a broader deal, which kept wage inflation in check and engendered all the beneficial effects that follow (Pochet 2002; Hancké & Rhodes 2005).

One small irony should not go unappreciated here: the highly organized northern economies, often held up as shining examples of tri-partite or bi-partite neo-corporatism, transitioned into the monetarist macro-economic model underlying the DM-bloc through major social conflicts. The southern EMU member-states, on the other hand, often considered 'ungovernable' because of their highly ideological labour unions and adversarial employment relations systems, adopted a considerably more conciliatory approach. With governments and central banks as the drivers of monetary regime change, organized labour in the south appeared to have accepted the new policy regime as a *fait accompli* and worked within the margins that this regime offered.

The effects of these reorganizations of the macro-economic policy framework everywhere, but especially in the south, have been nothing short of spectacular. All the major Maastricht convergence criteria were easily reached, and all applying EU member-states save Greece 'irrevocably' fixed their exchange rate to the new single currency in 1999 (Greece joined in 2001). EMU was born.

### **III.3 Act III: Labour unions, wages and the ECB**

The introduction of the Euro in 1999 set the stage for the third and final act of the drama. Most citizens of EMU member-states associate the Euro with ease of travel, companies in the euro-zone associate it with exchange rate stability and price transparency, and financial markets with a credible low inflation regime. These aspects of the Euro are certainly important; its essence for the purposes of this paper, however, lies elsewhere. The introduction of the single currency dramatically changed the institutional framework of macro-economic policy, both within and between countries. First of all, it produced a pro-cyclical monetary regime. The single nominal interest rate, reflecting the ECB's two per cent inflation rate target, translated into excessively accommodating real interest rates (the nominal interest rate minus the actual inflation rate) in countries with inflation above the two percent, and excessively tight monetary policy in countries with a low inflation rate. That fed into higher growth and higher inflation in the first group and lower growth in the second group, thus pushing both groups of countries in opposite directions: inflation rose in the high-inflation group in the first period and fell in the low-inflation group—thus fuelling asset price inflation in the first and stifling growth in the second group of countries.

These perverse effects could easily be off-set through fiscal policy. But two considerations make that a less appetizing choice than it would seem. Governments are on the whole loath to impose taxes, especially in times of fiscal surplus: fiscal tightening to counter monetary relaxation is thus very hard to implement. The Stability and Growth Pact (SGP), in addition, makes annual deficits above three per cent of GDP problematic: that raises the bar for counter-cyclical fiscal policy in a tight monetary regime. (The SGP, in fact, operates in a moderately pro-cyclical fashion as well, by rewarding countries with a surplus and punishing countries with a deficit, thus exacerbating the problems that pro-cyclical monetary policy produces.)

Against the background of this shift in the international regime toward a pro-cyclical monetary policy, domestic wage-setting regimes witnessed an important but underappreciated structural shift. EMU transferred stewardship of the economy from national central banks, with all the power they held over wage setters and governments, to a single ECB, with the implicit perverse effect that the domestic pressure, exercised by the central bank, on wage setters in EMU member-states effectively disappeared. Many observers in the late 1990s predicted a massive inflationary scramble as a result: since the ECB is unable to retaliate against one union in one country—in contrast to how national central banks had increasingly threatened tightening during the previous two decades—excessive wage rates could no longer easily be punished (Iversen & Soskice 2001; Hall & Franzese 1998). To take an example: in the limiting case even the German engineering union IG Metall, the leader in most wage settlements in the country and one of the largest and strongest trade unions in the world), saw its weight in the central bank's reaction function diminish from nominally about thirty per cent for the Bundesbank (but in real terms almost certainly much more

because of the union's pilot function for wages throughout Germany) to (again nominally) about ten per cent for the ECB: engineering accounts for roughly one-third of German GDP, and Germany for roughly one-third of Euro-zone GDP. Since every labour union in every country finds itself in a parallel position, all have an incentive to exploit their new-found freedom: a classic collective action problem that produces wage inflation everywhere—thus the argument.

The first ten years of EMU demonstrate rather convincingly that this is not what happened. While wage inflation rates diverged between member states, EMU's aggregate inflation rate remained low throughout the first decade, usually hovering between two and three per cent. Wage growth was, on the whole, moderate, and there were very few signs of the inflationary scramble that many observers feared. The introduction of the single currency did reveal, however, that wage setting in the member states were aggregations of two increasingly divergent trajectories: the exposed sector's path, on the one hand, where markets had sufficient power to contain excessive wage demands, and the sheltered sector's, on the other, where international competition (and in the case of the public sector any competition whatsoever) which restrains wage growth was absent. All other things equal, wage inflation was unlikely in the former, lest the export sector began to price itself out of the market and workers therefore out of a job, while it was, for the mirror reason of job stability, almost certain to emerge in the latter. The institution of EMU thus, somewhat perversely, reopened a cleavage within the labour unions that had been closed in the previous decades (Johnston 2012).

Yet, things were not wholly equal across EMU's member-states: in north-western Europe, wage coordination across different sectors constrained the public sector in its wage setting—mostly because shadowing wage rates in the leading manufacturing sector possibly secured the best medium-term wage deal for the public sector, but often also because of coercion, as in Austria and Belgium, where institutional and legal constraints, such as labour law, budget rules (Hodson 2011: ch. 5) or organizational power within the union confederation, imposed a hard ceiling on public sector wages (Johnston & Hancké 2009; Johnston 2012). In countries where the exporting manufacturing sector was not the leading trade union, however, and/or where public sector unions were capable of extricating themselves from the wage-setting system that revolved around the leading export-sector unions, wages (expressed in ULC) in the public and in the manufacturing export sector diverged rapidly. This was the case in Ireland, Portugal, Spain, Italy, and Greece for much of the first decade of EMU up until the crisis of 2008. Since domestic wage inflation is, in effect, the weighted average of sheltered (including, and possibly dominated by, public) sector wage inflation and exposed (manufacturing and other export) sector wage inflation, inflationary pressures thus started to rise in these countries.

Rising wage inflation in the public sector is, in principle, relatively easy to compensate in the exposed (export) sector, as long as the productivity rate of the latter is high enough—which it

is in much of the key manufacturing sectors—and wages grow at a moderate enough rate. But in some cases the export sector may have only a low potential to compensate, because it consists primarily of relatively low value-added sub-sectors, because the export sector is too small compared to the sheltered sector, or the export sector might simply set its own wages above productivity regardless of the consequences, thus exacerbating the inflationary pressures emanating from the sheltered private and public sectors. Under those circumstances, the ability to compensate for high wage inflation in the sheltered (public) sector is drastically limited, aggregate domestic wage inflation rises faster and higher, and the competitiveness of the export sector falls rapidly as a result of what is, in effect, an appreciation of the real exchange rate. That was also exactly what we witnessed in the EMU economies that faced important public debt problems in the 2010-11. Before the introduction of the Euro in 1999, manufacturing wages and public sector wages roughly followed the same pattern in all prospective member states. From 1999 onwards, however, the evolution of the two diverged sharply: manufacturing wages across the euro-zone remained tightly controlled (expressed in unit labour cost terms, they were negative, in fact, as Johnston 2012 demonstrates), while public sector wages were on an upward trajectory until 2007.

This potentially explosive reconfiguration of relations between the sheltered and the exposed sectors took place against the background of the newly instituted centralized monetary policy in EMU. The ECB's single interest rate, which reflects the distance from the central bank's asymmetric inflation target of two per cent, has had very different consequences for different regions within EMU—which is what the member states in the single currency area effectively have become. Somewhat ironically, therefore, by implicitly rewarding high-inflation countries with a lower real interest rate, the ECB ended up *de facto* also sanctioning excessive wage claims by the public sector.

Two inadvertent consequences of EMU thus interacted to produce the dramatic outcomes we saw in the late 2000s and after. One of these is related to the structure of wage bargaining: the introduction of the ECB lifted the restraints by central banks on wage-setting in the public sector in each of the member states. If wage coordination remained successful in the absence of a tough reaction by the central bank, wages in the public sector remained contained; if not, a dramatic divergence of wages (expressed in ULC terms) followed, inflation rose, and export competitiveness fell. The second relates to the pro-cyclical effects of a single monetary policy: EMU's single interest rate means that low-inflation countries have a higher real interest rate than high-inflation countries, thus fuelling inflation in the latter and thereby exacerbating the structural competitiveness problems. Fiscal policy appears unable to alleviate these pro-cyclical effects, and even the accompanying counter-cyclical evolution of the real exchange rate (which falls in low-inflation and rises in high-inflation countries, thus improving competitiveness in the first) compensates but far from totally, since it only applies to the export sector. In fact, this divergence of relative competitiveness is actually part of the problem: it feeds in to the dramatic current account imbalances across EMU.



## IV. Conclusion

At the time of writing this paper, in late 2011, many new initiatives have been floated to save the Euro. All of these, however, remain informed by the need for fiscal restraint and very little is done to deal with the structural current account imbalances that were identified here as being at the heart of the problem. The plan, proposed by France and Germany and discussed at the summit on 8 and 9 December, calls for an intrusive ‘fiscal union’, in which governments that run sustained fiscal deficits will be held to account. Perhaps this initiative will, in a more expansive version, be complemented by Euro-bonds, possibly underwritten by the ECB. If all goes well, such an arrangement will alleviate the immediate pressures on the Euro-zone.

However, if the analysis in this paper has any traction, the new governance arrangements of EMU will not address the underlying structural problems of EMU, which are related to the sharp divergence of competitiveness between the two blocks of economies against the background of a one-size-fits-all monetary policy. Because of the demise of the nested arrangement that preceded EMU, in which central banks held wages in both the exposed and sheltered sectors in check, EMU has become a monetary union that invites these imbalances. And it is hard to see how these can be addressed. The southern GIPS and Ireland would have to increase their exports in absolute and relative terms significantly by producing and exporting more high value-added goods and services, while Germany and its neighbours would have to reorient their domestic economies away from exports into private and public consumption. Easy to imagine on paper but nigh impossible in practice—and the new EMU governance arrangements are not helping.

One could imagine Italy and Spain, and possibly Ireland once it finds itself on its feet again, to slowly sort out their competitiveness issues—even though that would probably take at least a decade or more of economic growth in the euro-zone, something which itself will take a long time to materialize in today’s austerity-driven political-economic climate, and the construction of domestic institutional arrangements to underpin these shifts in competitiveness. It is much harder to imagine Greece and Portugal to do so, though, since none of these countries have a competitive manufacturing or even modern sector to speak of on which they could build this adjustment strategy. In addition, all of them lack domestic institutions such as well-developed training systems, strong trade unions and employers associations, coordinated wage bargaining institutions and cooperative workplace labour relations that would allow them to make a move up-market in their export profiles, and it is not immediately obvious if and how they could build them. Italy may have succeeded in reorganizing its political economy under the aegis of the 1993 social pact (Herrmann 2005), which suggests that it is possible—but the considerably more modest results in the fields of labour relations, workplace and supplier upgrading in France during the 1980s (Levy 1999) suggest that this success is far from a foregone conclusion. While these countries are busy

sorting out their domestic economies, then, Germany and its neighbours would have to be persuaded to do something that they seem to think of as shooting themselves in the foot: develop wage and government policies that lower competitiveness, and rely on domestic consumption as an engine of growth for the first time since World War II. In all, this is a tall order for EMU, even if all countries agreed on these steps. Sadly, they do not.

The upshot of this analysis is therefore clear: EMU is structurally in trouble unless it develops two mechanisms that alleviate the imbalances that have grown in the past decade. The first is a mechanism that counteracts excessive inflation divergence when it emerges: a proper fiscal union, with transfer mechanisms through which fast-growing countries contribute more to a central pool than slow-growing ones—Greece, Ireland and Spain in the past, Germany and north-west Europe today—would produce that. This would moderate growth and inflation somewhat in the fast-growing countries and compensate for the ECB-imposed deflation in the slow-growing countries and thus mitigate the current account divergences. The second is that Germany and its neighbours have to rethink their domestic economies away from the massive reliance on exports to the rest of EMU, and adopt more classical Keynesian policies geared toward domestic demand—at the risk, yes, of higher inflation, which both the ECB and Germany will have to take on the chin. In short, EMU needs a bottom-up redesign if it is to survive. The rest, including what we saw in Brussels in December 2011, is tinkering in the margins.

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